THE FEDERAL RESERVE BANKS[1]

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THE federal reserve banks proposed by the pending currency bill may be briefly described. They are bankers' banks and they are intended to do for the banker what he himself does for the public. They are to economize and systematize his funds and his dealings, to facilitate his communication with his associates and rivals, and to supply him with accommodation when he needs it. If this is what the so-called regional banks are to do, and if they can successfully do it, they need neither explanation nor defense, for both their purpose and their method are as old as modern business.

Indeed, there is nothing new about the idea of the regional reserve banks. Some students of the currency question have traced them back to the fatherhood of ex-Senator Aldrich of Rhode Island. They have been said to be identical in organization and in purpose with the central reserve association to which his name has been attached. But these are superficial students of the situation. They should carry their studies at least as far back as the Fowler federal reserve bank bill of 1908, or the Muhlemann central reserve bank plan of several years earlier. Better still, they might consider the type of organization of our clearing houses and the conditions under which the latter have for years past aided and perfected the operations of their member banks. There is no idea in the Aldrich bill that can properly be claimed as a distinct novelty nor is there any fundamental idea in those phrases of the new currency bill relating to the organization of the federal reserve banks which was either drawn from the Aldrich bill as such or is original with itself. The merit of the Aldrich bill and of the new measure lies in the fact that both seek to apply familiar and

[1] Read at the meeting of the Academy of Political Science, October 14, 1913.

accepted ideas with reference to coöperation in banking. We can neither impute it unto the new bill for righteousness that it contains some ideas identical with the Aldrich plan nor can that fact be used to condemn it. Efforts in both of these directions have been failures thus far and will continue to be so.

Inasmuch as the idea of combined reserves and of united bank resources, controlled and administered in the interest of their owners and of the whole community, is neither new nor open to controversy, we may accept the broad, basic idea of the so-called regional banks as definitely settled. All that I am justified in presenting to you, therefore, is some matter relating to the detail of the plan for creating the proposed institutions. With reference to this matter of detail there are a few interesting points, most of which, however, have already received some attention.

The first in logical order, perhaps, is the capitalization of the banks. Gloomy predictions have been made concerning the inadequacy of the capital suggested. The new bill requires every member bank to contribute ten per cent of its own capitalization in current funds and it provides that no regional bank shall be organized with a capital less than $5,000,000. Many who have computed the probable working of this scheme have noted that owing to the great concentration of bank capital in the eastern states the proposed reserve banks in the South and West would have small capitals, some of them probably not much over the $5,000,000 minimum. Since the total capital of the reserve banks would be only about $105,000,000 they have argued that the twelve banks suggested would have an average capitalization of less than $9,000,000 each and that with the smallest the danger would be great that they would be unable in times of stress to fulfil their function. Those who thus argue fail to understand the fundamental elements of the proposed plan. The plan is essentially a scheme for combining reserves. It provides that when the various reserve banks have been organized their members shall place with them a specified minimum amount of their reserves while it is made an inducement to them to deposit an additional amount. Assuming that the total deposits of the national banks of the United States

subject to reserve requirements are $7,500,000,000, the amount which would be placed with these banks were they to comply with the requirement that at least five per cent of their outstanding deposits shall be balances with the reserve banks would be $375,000,000, while it is probable that in addition enough more to make the sum around $600,000,000 might be left with the new institutions. If the latter should prove to be the actual cash held by the reserve banks in trust for other banks, after the amount of rediscounts to be granted had been settled and adjusted, the average to each of the proposed twelve banks would be $50,000,000. In addition to this would be their capital and their share of the government deposits. The latter would probably average at least $15,000,000 per bank so that a representative of the new reserve institutions would start with from $65,000,000 to $75,000,000 of cash resources. Now I submit that a bank possessing $65,000,000 of clear cash is by no means a puny or weak institution. A comparison with some foreign banks bears out this view. Moreover, it must be evident that in any district or region of territory, if it be true that the resources of the reserve-holding bank of this kind are too small, the meaning simply is that the member banks ought to keep larger reserves. The basic error of those who complain of the reserve banks' capital is this: they seem to suppose that the banks are to be organized on a competitive business basis. Nothing of the kind is true. Indeed, it might serve well enough to organize the new banks without any capital or with only a nominal capitalization. Their strength and the whole test of their fitness and sufficiency depends upon their success as reserve holders. Their capitalization is of relatively little importance, except for the purpose of making a start and furnishing a buffer against possible loss.

A second matter, which is closely interrelated with the capitalization of the proposed banks, and to which considerable attention has been given, is the question of stockholders. Under the proposed plan every national bank must join the system or cease to be a national bank within a year. Much has been made of this so-called compulsory provision, and many severe epithets have been applied to it. It has been

called "socialistic," but unfortunately socialism is no longer a name to conjure with. It it were socialistic, perhaps the fact would make as many friends for the scheme as it would enemies. To us I suppose the interesting thing is whether the so-called compulsory provision is a good one or not. Let me say frankly that I think this matter is an open question. Certainly it would be very desirable if every bank called national were a member of a truly national system, subject to national jurisdiction, performing national duties and entitled to national support. But the other way of handling the situation has its advantages. In drafting the pending currency bill it was supposed that the banks would not care to have non-bankers operating the reserve banks, and so after much travail of spirit it was determined to yield this point and to have the new banks organized by bankers only. But strange to say, this was a case where, as the poet has expressed it, "A man's loss came to him from his gain, darkness from light, and from knowledge, ignorance." No sooner had the measure been promulgated than it was objected to upon this very score. It is probable that by making membership in the reserve banks voluntary and by throwing open to the general public the right to subscribe to the capital an object would be attained which was earnestly sought by the framers of the Aldrich bill in the multitude of cumbersome provisions by which that measure attempted to get business coöperation. In other words, a real interest on the part of merchants would be secured in the way referred to—by throwing open the subscription to the public. I believe that my audience is composed at least in part of merchants, and to them I wish to say that I believe it right for them to have a share in the control of the reserve banks. Perhaps a direct subscription to capital stock with a limited voting power would be the best way to get it. But would the banks themselves, which now complain of the compulsory features of the new plan, be satisfied with a scheme in which they had to deposit their reserves, whether stockholders or not, in the new reserve banks, while the latter were in part at least controlled by merchants and business men?

A third point with reference to which much mystery has been made and regarding which many abstruse screeds have

been written is the question whether the proposed reserve banks are too numerous. This is not merely a matter of capitalization. It has been asserted that the banks in question if organized to the number of twelve would be unable to do the work assigned, would be unable to control gold movements, would act inharmoniously, and would in various other ways prove to be a broken reed for the community to lean upon. This is a matter in which a limited amount of common sense is needed and very little more. Suppose we look at the continent of Europe. We find there the banks of France, Germany, Russia, Austria-Hungary, Italy, Belgium, Switzerland, Spain and various others. Some of these banks have very large resources, others relatively small ones. They are not more widely separated from one another by distance than the institutions of Maine and California or of Florida and Alaska. The difference of climate and of business methods is hardly greater between the north and south of Europe than between the north and south of the United States. Now suppose that through some historical course of development this continent had been broken into a variety of national areas. Would it have been impossible to establish a coöperative central banking institution in each such area? Would it have been feasible for such institutions to regulate the supply of gold going into and out of those areas and to control the credit supply in each? Why should it have been necessary to organize one single reserve-holding institution for the whole continent? Again, we see to-day north of our northern border twenty-seven strong institutions with hundreds of branches operating effectively and soundly and controlling the reserve resources of Canada in a satisfactory and efficient manner. Are there too many of them? If there are, the number will be reduced as in times past it has been. If Canada can support at present twenty-seven such institutions, can the United States not support twelve reserve-holding institutions? There is no argument from experience, no analogy from conditions in other countries that can be taken even remotely to sustain the demand for the consolidation of the reserve banks into one. How many there should ideally be, experience only can absolutely determine. It is fundamentally

necessary, therefore, that, whatever be the number with which we start, the way to the creation of more institutions of the kind shall be kept open. Neither should they be chartered for too long periods nor should their number be limited in any rigid manner nor should their charters be irrepealable during their life. Experience should dictate how large a group of banks is necessary to act together and yet get the benefits of coöperation and how large a group is likely to become unwieldy, over-centralized and difficult to control. For the present, investigation shows that twelve such banks may be a convenient number, while later experience will furnish the conclusive evidence whether the number should be increased or diminished.

Fourth, much attention has been lavished upon the relation which should exist between federal reserve banks. The pending bill proposes to make them independent of one another, except in so far as exchange balances may have to be kept in order to facilitate inter-bank payments. In time of emergency, the bill provides that the Federal Reserve Board shall have power to intervene and to require a given bank to rediscount under very stringent and limited conditions the paper of another, or to permit one to make such a rediscount at will if it desires. This provision also has been described as "socialistic," and has been condemned on that score, it being asserted that such an authority takes the control of the bank's own funds out of its own hands. Strangely enough, such criticism comes primarily from those who would like to see a single central reserve association established, notwithstanding that rediscounts between different parts of the country would be the staple business of such a reserve association. They seem also to ignore the past action of clearing-house banks in making their resources a common fund in case of disaster. And, strange to say, they are identical with those who want permission to have the reserve banks deal freely with one another. Consistency is important in banking as in everything else. Essentially the answer to this question of relations between reserve banks is found in the fundamental query, what are the reserve banks for? Not to make money beyond a fair moderate profit; not to compete with member banks beyond the point where such competition

is necessary to fulfil their purposes. Regular business with one another should be out of the question. There is no reason for altering that provision of the pending bill which forbids them to do any such business except in transferring funds.

There is a fifth point that, because of the space that has been given to it in some recent discussions of the subject, is worthy to be noted. This is the function of the so-called regional banks in handling domestic exchange. The bill provides that the banks shall accept certain checks on deposit from their stockholders without charge for exchange or collection and that member banks may if they choose make a charge to their customers for their services in transmitting funds. The object of this provision is evident. It would substitute a system of clearing country checks for the present method of collecting them and it would establish parity of exchange between all places in a federal reserve district and then between the federal reserve districts themselves. The banks could charge any fees they choose for exchange services, but in fact they would not do so. They would have to give their customers the advantage of the collection system thus introduced. Upon this seemingly innocent provision has been vented an immense amount of criticism. Most of it is simply reducible to a statement on the part of banks that they need the income they now derive from exchange services, a frank and blunt way of meeting the proposition that hardly needs discussion. I do not think it will appeal to the broad-minded banker who views his profession as a semi-public occupation. If we devote attention solely to the genuine theoretical aspect of this matter we shall arrive at a truer conception of the principles involved than if we look at the question through the distorting glass of commercial selfishness. Many years ago, when bank loans were made almost entirely by the issue of notes, this same problem was raised on account of the excessive charges for the transmission and redemption of notes to which the holders thereof were subject. The struggle through which the community then passed was closed by a unanimous agreement that henceforward the bank-note currency of the country should invariably be redeemable throughout the area of the nation at par. This general agree-

ment found expression in the national bank act, which provided for the compulsory receipt by every national bank at all times of the notes issued by every other national bank. The consequence has been that the national bank notes have invariably been received throughout the United States absolutely at par and without any charge for collection. Now after a long period of development we are engaged in revising the banking laws of the country, and we are confronted by the same question as in former times. But to-day the currency of the country consists essentially of credit instruments. The notes have become a minor matter relatively unimportant to the active business man, save under peculiar conditions. But the principles in the one case are exactly the same as those that controlled in the other. Fundamentally they indicate that whenever a banker creates an instrument of circulation it is his duty to maintain that instrument at par throughout the territory in which it circulates in order that no one may lose by a discount upon the credit currency thus provided. If in this process of maintenance at par the banker incurs expense, then he should charge a sufficient sum for the service he performs in creating the credit to warrant him in his action, and he should do it at the time he establishes the credit. The federal reserve banks will operate to bring about this end, and in so doing they will perform the same service for the credit instruments of the country that was rendered in former times by the Suffolk Bank of Boston, when after great trial and tribulation New England institutions were practically compelled to keep a deposit with the Suffolk for the redemption of their notes.

One final point in connection with the organization of the federal reserve banks is worthy of special note. It has been suggested that the effect of the creation of these reserve banks would be to bring about a very serious contraction of credit. To go in detail into the question whether such a contraction is reasonably to be feared or not under the proposed plan would take very much more than the limited time at my disposal and I cannot therefore venture to undertake it. Let me say in brief that the most careful computations thus far made show that there would be no such contraction as has been feared, even if the

reserve called for under the plan were to be established by making direct cash deposits with the federal reserve banks. Were the deposits to be made in that way, the result would be to call in perhaps $100,000,000 of net cash not now in the banks or at all events not now used by banks for reserve requirements. This however would be much more than offset by the immediate effect of the placing of the government funds in the banks and their consequent availability for immediate use. When the added power of credit extension due to the introduction of the rediscount system is considered, there is no comparison between the possibilities of the proposed reserve bank plan and that of the present banking system. The reserve banks would be able, if they saw fit, to increase by an enormous amount the accommodations now granted to the public. It has been computed that this possible extension would be $2,000,000,000. Whether to grant such an extension or not is a question of policy which the management of these banks could be expected to settle wisely and in the interest of the public as well as in their own. That they would permit any contraction to take place is, I think, out of the question.

In short, the reserve bank plan proposed furnishes a workable method of attaining the objects for which currency and banking reformers have so long striven. There is nothing in it that is unworkable or that may not reasonably be accepted by those who believe in the general principle of economy and combined control of bank reserves. If in their judgment there are elements in the plan which may prove clumsy, efforts should be directed to smoothing these defects away. It can be successfully done without altering either the general plan or the purpose of the bill now proposed. It would be strange indeed if the chance of attaining within a very short time what has been sought for years should be discarded merely because the method of reaching it was not in all respects to the liking of those who are to put it into operation.